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The Bankruptcy Tax Act (Act) was signed into law on December 24, 1980.[1] The product of over seven years of legislative deliberation,[2] the

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1. Pub. L. No. 96-589, 94 Stat. 3389 (1980). The text of the Bankruptcy Tax Act can be found at 49 U.S.L.W. 219-26 (1981).

2. Proposals to amend the Internal Revenue Code (the Code) to provide for the comprehensive tax treatment of bankruptcy originated in 1973 with the Commission on the Bankruptcy Laws of the United States. *See* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, PART I, H.R. DOC. NO. 93-137, 93d Cong., 1st Sess. 199-219 (1973) [hereinafter cited as PART I OF THE BANKRUPTCY COMMISSION REPORT] and REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, PART II, H.R. DOC. NO. 93-137, 93d Cong., 1st Sess. 293-97 (1973) [hereinafter cited as PART II OF THE BANKRUPTCY COMMISSION REPORT].

In 1973 the House of Representatives seriously considered passing an act dealing with the tax consequences flowing from bankruptcy or insolvency. *See A Bill to Amend the Internal Revenue Code of 1954 to Conform it to Changes in the Bankruptcy Law: Hearing on H.R. 9973, Before the House Comm. on Ways and Means*, 95th Cong., 2d Sess. (1978) [hereinafter cited as *House Hearings on H.R. 9973*]. But for some undetermined reason this proposal was not enacted.

A version of the Bankruptcy Tax Act was first considered by the House of Representatives in Fall 1979. *See Proposed Amendments to the Internal Revenue Code of 1954 to Provide for the Tax Treatment of Bankruptcy, Insolvency, and Similar Proceedings, Hearing on H.R. 5043, Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 96th Cong., 1st Sess. (1979) [hereinafter cited as *House Hearings on H.R. 5043*]. Because considerable controversy was generated during the hearings before the Subcommittee on Select Revenue Measures as to the merits of Proposed H.R. 5043, written comments on the proposed tax bill were solicited. *See* Written Comments on Certain Aspects of H.R. 5043, Bankruptcy Tax Act of 1979, Submitted to the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 96th Cong., 2d Sess. (February 29, 1980) [hereinafter cited as Written Comments]. After receiving the written comments on proposed H.R. 5043, the House Ways and Means Committee issued

Act contains the tax rules applicable to individual, partnership, and corporate bankruptcies.[3] Indeed, the Act's title is something of a misnomer, as the Act even embodies provisions which have a substantial impact on transactions undertaken by solvent taxpayers.[4]

Because the Act is so broad, it is not possible to discuss all of its provisions adequately within a single format. Consequently, this article will focus only on those provisions of the Act which affect insolvent corporate debtors. Because debt discharge is a central feature of corporate insolvency proceedings,[5] this article will examine in-depth how the Act modifies the rules governing the corporate recognition of income from the discharge of indebtedness.[6] Also, this article will discuss how the Act alters the tax consequences flowing from corporate in-

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its report on the bill without substantially altering many of the more controversial portions of the bill. *See* HOUSE COMM. ON WAYS AND MEANS, REPORT ON THE BANKRUPTCY TAX BILL OF 1980, H.R. REP. No. 96-833, 96th Cong., 2d Sess. (1980) [hereinafter cited as HOUSE REPORT ON H.R. 5043]. The Senate then considered the House's version of the Bankruptcy Tax Act and modified the more controversial sections of the bill. *See* SENATE FINANCE COMM., REPORT ON THE BANKRUPTCY TAX BILL OF 1980, S. REP. No. 96-1035, 96th Cong., 2d Sess. (1980) [hereinafter cited as SENATE REPORT ON H.R. 5043]. The Senate version of H.R. 5043 was the version of the Bankruptcy Tax Act that finally was enacted into law. *Compare* the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389 *with* the version of the act proposed by the Senate Finance Committee, *reprinted in* SENATE REPORT ON H.R. 5043 *supra*, Appendix.

For a discussion on the more controversial sections of the Bankruptcy Tax Act, see notes 133-49 and accompanying text *infra*.

3. *See* the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389. The Bankruptcy Tax Act is divided into seven sections. Sections 4 and 5 of the Act deal exclusively with the tax treatment to be accorded insolvent or bankrupt companies. Section 3 of the tax act deals with the tax treatment accorded insolvent or bankrupt individuals and partnerships. Section 2 of the act provides for the tax treatment of debt discharge. Because individuals, partnerships, and companies often have debt discharged in bankruptcy proceedings, section 2 of the tax act contains rules applicable to all three types of entities.

4. The Bankruptcy Tax Act has been subject to some criticism because it incorporates provisions which deal with transactions outside of bankruptcy. *See House Hearings on H.R. 5043*, note 2 *supra*, at 47 (statement of David A. Berenson, Chairman, Bankruptcy Task Force, American Institute of Certified Public Accountants); Written Comments, *supra* note 2, at 76 (statement of Machinery and Allied Products Institute, submitted by Charles W. Stewart). David Berenson states that the Bankruptcy Tax Act is an unlikely place for amendments affecting solvent taxpayers. *House Hearings on H.R. 5043*, *supra* note 2, at 47. Charles Stewart states that the proposals affecting solvent taxpayers are not germane to the balance of the bill. Written Comments, *supra* note 2, at 76.

The Bankruptcy Tax Act affects solvent taxpayers because it modifies sections 108 and 1017 of the Code. For a discussion on sections 108 and 1017 of the Code and Bankruptcy Tax Act amendments thereto, see notes 11-18 & 31-41 and accompanying text *infra*.

5. *Accord, House Hearings on H.R. 5043*, *supra* note 2, at 8 (statement of Daniel I. Halperin, Deputy Assistant Secretary for Tax Policy, Department of the Treasury). Mr. Halperin states that "the cancellation of debt is an important aspect of bankruptcy . . . ." *Id.*

6. *See* notes 9-54 and accompanying text *infra*.

solvency reorganizations undertaken pursuant to Chapter XI of the Bankruptcy Reform Act of 1978.[7] Finally, there will be some discussion of certain miscellaneous provisions of the Act dealing with the liquidation of bankrupt companies and the exemption from personal holding company status accorded bankrupt companies.[8]

I. THE DISCHARGE OF INDEBTEDNESS RULES

In *United States v. Kirby Lumber Co.*[9] it was held that a taxpayer recognizes income from the discharge of indebtedness. The holding of *Kirby Lumber Co.* is embodied in section 61(a)(12) of the Internal Revenue Code (the Code), which provides that the gross income of a taxpayer includes income realized from the discharge of a debt.[10]

However, under sections 108 and 1017 of the Code, as they existed prior to the passage of the Bankruptcy Tax Act, a debtor did not have to recognize income upon the cancellation of indebtedness if the debtor consented to a reduction in the basis of his assets.[11] If the debtor elected to reduce asset basis, basis was reduced pursuant to treasury regulations issued under section 1017 of the Code.[12] If the debtor did not elect to reduce asset basis, income was recognized in an amount equal to the debt cancelled.[13]

In theory, the election provided to debtors under section 108 resulted only in tax deferral, not tax avoidance.[14] The debtor realized

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7. *See* notes 55-124 and accompanying text *infra*.

8. *See* notes 125-32 and accompanying text *infra*.

9. 284 U.S. 1 (1931). In *Kirby Lumber Co.* a corporation issued bonds with a face value of $12,126,800 and for which it received face value. *Id.* at 2. In the same taxable year the corporation repurchased the bonds for $11,989,278.70. The Internal Revenue Service (the Service) argued that the difference of $137,521.30 constituted taxable gain. *Id.* at 2-3. The Supreme Court agreed, holding that the corporation clearly realized "an accession to income." *Id.* at 3.

10. I.R.C. § 61(a)(12). This section of the Code provides that "gross income means all income from whatever source derived, including (but not limited to) the following items . . . (12) Income from discharge of indebtedness." *Id.*

11. I.R.C. §§ 108, 1017 (amended 1980).

12. *Id.*

13. *Id.*

14. *Accord*, Written Comments, *supra* note 2, at 59-61 (statement on behalf of General Telephone and Electronics Corp.); *id.* at 61-63 (statement of R.D. Lannert made on behalf of International Harvester Co.). General Telephone and Electronics Corp. stated:

> The basis adjustment is merely a tax deferral device that postpones, but does not permanently exclude, the recognition of income. . . . The effect of such treatment has been that the taxpayer has been able to defer the tax on that amount until future years when he receives lower depreciation deductions and/or cash on the sale of the asset.

Id. at 60. R.C. Lannert stated:

> The Sections 108 and 1017 election has been characterized as allowing a corporation to reduce the basis of its assets by the gain realized on the repurchase of its

greater income in the future, and therefore incurred a greater tax liability, because the debtor lost future depreciation deductions on the assets which had their basis reduced.[15] Unfortunately, in practice the basis of non-depreciable property could be reduced, and thus, the recognition of debt discharge income could be permanently deferred.[16] Moreover, under former section 108, it was possible to convert ordinary income into capital gain.[17] Debt discharge normally results in the realization of ordinary income, yet if a debtor elected to reduce the basis of a capital asset, and subsequently sold the asset, the debtor realized only capital gain.[18]

Other exceptions to the holding of *Kirby Lumber Co.* were fashioned by the courts and the Internal Revenue Service (the Service).[19] For example, in *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*,[20] it was held that an insolvent corporation does not recognize

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own debentures rather than to recognize this amount in income. In point of fact, rather than escaping recognition entirely the full amount of this income will be recognized, but over a period of time. This reduction in basis can equally well be described as a loss of depreciation deductions over the life of the assets whose bases have been reduced.

Id. at 62.

15. *See* note 14 *supra*.

16. *See House Hearings on H.R. 5043*, *supra* note 2, at 93 (statement of Richard Bacon); Written Comments, *supra* note 2, at 35 (statement of Richard Bacon); *id.* at 51-52 (statement of Jeffrey D. Eicher). Richard Bacon states that one of the principal defects of the §§ 108/1017 election is that "[a]n electing taxpayer can defer tax indefinitely by reducing the basis of land or other nondepreciable assets which he plans to hold indefinitely. . . ."
Id. at 35.

17. *House Hearings on H.R. 5043*, *supra* note 2, at 93 (statement of Richard Bacon); Written Comments, *supra* note 2, at 35 (statement of Richard Bacon); *id.* at 51-52 (statement of Jeffrey D. Eicher). Richard Bacon stated that a major defect of section is that "[t]he sale proceeds from the asset qualify as all capital gain, whereas the original debt cancellation would have given rise to ordinary income." *Id.* at 35. Jeffrey Eicher stated that the election granted by section 108 to reduce property basis permits the "conversion of ordinary income into capital gains." *Id.* at 51-52.

18. *See* note 17 *supra*.

19. *See* notes 20-22 and accompanying text *infra*.

20. 70 F.2d 95 (5th Cir. 1934). In *Dallas Transfer & Terminal Warehouse Co.* a corporation owed its creditors $178,941, but had assets valued only at $152,470. Therefore the debtor company had a negative net worth of $26,471. The largest debt owed by the corporation was $107,880 for rent past due. The lessor agreed to cancel the rent obligation in exchange for receiving property from the debtor valued at $17,507 and having an adjusted basis of $14,513. The Service claimed that the corporation realized $93,367 in income from the discharge of debt when the rent obligation was cancelled in exchange for the receipt of the property. The United States Court of Appeals for the Fifth Circuit disagreed with the Service, stating:

[T]he cancellation of the respondent's past due debt to its lessor did not have the effect of making the respondent's assets greater than they were before that transaction occurred. Taxable income is not acquired by a transaction which does not result in the taxpayer getting or having anything he did not have before. Gain or

income from the forgiveness of its debt obligations. The courts also held in *Commissioner v. Motor Mart Trust*[21] and in *Commissioner v. Capento Securities Corp.*[22] that a debtor company does not recognize

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profit is essential to the existence of taxable income. A transaction whereby nothing of exchangeable value comes to or is received by a taxpayer does not give rise to or create taxable income.

Id. at 96. If the debtor company still had a negative net worth after the debt cancellation, the result reached in *Dallas Transfer & Terminal Warehouse Co.* is theoretically sound. However, on the basis of the facts recited in the opinion, the result reached in *Dallas Transfer & Terminal Warehouse Co.* is questionable. Since $93,367 of debt was cancelled, and the debtor only had a negative net worth of $26,471, then the debtor corporation obtained a positive net worth of $66,896. To the extent there was an increment in assets above zero, it has been held that there is taxable gain. *See* Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289 (1937).

In *Lakeland Grocery Co.* the Board of Tax Appeals agreed with the Fifth Circuit that no income is realized where debt is forgiven, provided the debtor is insolvent both before and after the debt discharge. 36 B.T.A. at 291. However, in *Lakeland Grocery Co.* the debtor gave property worth $15,472 to its creditors in exchange for the cancellation of claims aggregating $104,710. *Id.* at 290. The debt cancellation resulted in the debtor having a positive net worth of $39,596. *Id.* The Board of Tax Appeals held that the debtor realized income to the extent it received "an increment to its assets clear and free of any claims of the creditors." *Id.* at 292.

21. 156 F.2d 122 (1st Cir. 1946). In *Motor Mart Trust* an insolvent corporation owed money to first mortgage bondholders, second mortgage bondholders, and to the trustees of the bondholders. The corporation also had preferred stock and common stock outstanding. In a bankruptcy proceeding, it was decided that the company should be financially restructured. The old shareholders would be eliminated, the first mortgage bondholders would receive both preferred and common stock, the second mortgage bondholders would receive just common stock, and the trustees would receive some common stock and cash. *Id.* at 123. On these facts, the United States Court of Appeals for the First Circuit held that no income was realized from the cancellation of indebtedness. *Id.* at 124. The court reasoned that at the time the debt was exchanged for stock, the creditors were, in essence, the true shareholders of the company, and thus, the transformation of the bondholders into shareholders just recognized economic reality. *Id.*

22. 140 F.2d 382 (1st Cir. 1944). In *Capento Securities* Raytheon Manufacturing Company had two subsidiaries, Raytheon Production Corporation and Capento Securities Corporation (Capento). The sole assets of Capento were bonds of Raytheon Production Corporation, which had a face value of $500,000 but which Capento had purchased on the open market for $15,160. *Id.* at 383. In 1935, Raytheon Production Corporation attempted to obtain a loan from First National Bank of Boston. *Id.* at 383-84. The Boston bank would agree to make the loan only if the bonds held by Capento Corporation were converted into stock. To meet the loan requirements of the bank, Raytheon Production Co. issued 5,000 shares of preferred stock, worth $50,000, to Capento in exchange for the bonds held by Capento. The Commissioner asserted that this exchange of debt for stock resulted in Raytheon Production Corporation realizing $450,000 in debt discharge income. The United States Court of Appeals for the First Circuit disagreed with the Commissioner, stating: "To substitute a capital stock liability for a bonded indebtedness . . . cannot be called a present realization of gain. . . . While the bond loan has been terminated, the amount borrowed is now committed to capital stock liability instead of to the liability of a fixed indebtedness." *Id.* at 386 (quoting Capento Sec. Corp. v. Commissioner, 47 B.T.A. 691, 695 (1942)). The Service now agrees with the holding of *Capento Securities*. In

income from the discharge of indebtedness where the creditors' claims are forgiven in exchange for stock. Finally, in *Revenue Ruling 58-600*[23] the Service held that a corporation's net operating loss (NOL)[24] need not be adjusted to reflect a reduction in the corporation's debt.

Thus, prior to the passage of the Bankruptcy Tax Act, debt reduction did not necessitate either a reduction in the net operating losses, or an increase in the income, of the insolvent corporate debtor.[25] Of course, it was clear under prior law that if debt discharge made an insolvent corporation solvent, income had to be recognized in an amount equal to the corporation's positive net worth.[26]

The Bankruptcy Tax Act codifies the holding of *Dallas Transfer & Terminal Warehouse Co.* by providing that an insolvent company may exclude from income any gain realized on the discharge of its debt.[27]

Revenue Ruling 59-222, 1959-1 C.B. 810, the Service held that the "substitution of common stock for debentures and unsecured claims does not effect a cancellation, reduction or discharge of indebtedness, but rather amounts to a transformation from a fixed indebtedness to a capital stock liability. *Id.* at 82.

23. 1958-2 C.B. 29. In Revenue Ruling 58-600 a foreign corporation established a sales subsidiary in the United States. From 1946 to 1951 the foreign parent made interest bearing loans to its United States subsidiary. In 1951 it made the loans non-interest bearing. From 1951 to 1956 the domestic corporation incurred substantial operating losses and by the end of 1955 had a large deficit in its earnings and profits account. In 1956 the foreign parent company cancelled the domestic subsidiary's debt in an amount sufficient to eliminate the deficit in the subsidiary's earnings and profits account. *Id.* The Service held "[t]he cancellation of the indebtedness of a taxpayer neither results in the realization of gross income nor affects the taxpayer's net operating loss carryovers from prior years where the taxpayer was insolvent before the debt cancellation and, after the debt cancellation, either remains insolvent or has no excess of assets over liabilities." *Id.* at 30.

24. The term "net operating loss" should be defined as it will be used throughout this article. Section 172 of the Code defines the term net operating loss (NOL) as the excess of allowable deductions over gross income. I.R.C. § 172(c). Section 172 of the Code also provides that an NOL may be carried back and applied against the gross income of a taxpayer for the three preceding taxable years and, if the loss is not fully utilized after being carried back, provides that the NOL may be carried forward and offset against the gross income of the taxpayer for the seven succeeding taxable years. I.R.C. § 172(b). If the loss is not fully deducted within the statutory period, it expires. Thus, under this statutory scheme, a corporate taxpayer which experiences earnings fluctuation may average its profits and losses, thereby substantially reducing its tax liability. *See* 27-3d Tax Management Portfolio at A-1 (BNA 1974).

25. *But see* notes 69-73 and accompanying text *infra* for cases where the Service argued that the debt discharge in bankruptcy results in the elimination of the debtor's NOL.

26. *See* Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289 (1937). For a discussion on *Lakeland Grocery Co.*, see note 20 *supra.*

27. I.R.C. § 108(a)(1)(A). Section 108 of the Code, as amended by the Bankruptcy Tax Act, now provides:

(a) EXCLUSION FROM GROSS INCOME

(1) IN GENERAL—Gross income does not include any amount which (but for

But the Act overturns *Revenue Ruling 58-600* by modifying sections 108 and 1017 of the Code.[28] Also, in modifying sections 108 and 1017, the Act eliminates the defects which permitted a taxpayer to avoid taxes permanently.[29] Finally, the Act limits the holdings of *Motor Mart Trust* and *Capento Securities Corp.*[30]

As modified, section 108 provides that unless a debtor elects to reduce basis, then to the extent that the debtor's indebtedness is discharged, the debtor's net operating loss carryover will be reduced.[31] The reduction of the NOL is to be done on a one-to-one basis; that is, for each dollar of debt discharged, the NOL is to be reduced by a corresponding dollar.[32] Once the NOL is reduced to zero, these other favorable tax attributes of the debtor become subject to reduction: (1) The investment tax credit, (2) the WIN tax credit, (3) the new jobs tax credit, (4) the gasohol tax credit, (5) the capital loss carryover, (6) the tax basis of depreciable property, and (7) the foreign tax credit.[33] All of these tax attributes are to be reduced in the order specified.[34] Unlike the NOL, however, the tax credits are to be reduced by one dollar for every two dollars of debt discharged.[35] The remaining tax attributes, the capital loss carryover and asset basis, are reduced in a one-to-one correlation with the reduction in debt.[36]

As previously mentioned, in lieu of first reducing its NOL, the insolvent corporation may elect to reduce its basis in depreciable property or in real estate held as inventory.[37] If the debtor elects to reduce asset basis, the reduction cannot exceed the aggregate of the adjusted basis for all depreciable property.[38] Once the asset basis is reduced to

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this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent . . . .

Id. A "title 11 case" is a proceeding under the Bankruptcy Act, 11 U.S.C. For a discussion on bankruptcy proceedings involving corporate taxpayers, see notes 50-62 and accompanying text *infra*. The Bankruptcy Tax Act defines "insolvent" as the "excess of liabilities over the fair market values of [the taxpayer's] assets." I.R.C. § 108(d)(3).

28. *See* notes 31-41 and accompanying text *infra* for a discussion of how the Bankruptcy Tax Act modifies sections 108 and 1017.

29. *Id.*

30. *See* notes 43 & 44 and accompanying text *infra* for a discussion on the exceptions to *Motor Mart Trust* and *Capento Securities*. *See* notes 21 & 22 *supra* for a discussion on *Motor Mart Trust* and *Capento Securities*.

31. I.R.C. §§ 108(b)(1), (2).

32. *Id.* §§ 108(b)(3)(A), (B).

33. *Id.* §§ 108(b)(1), (2).

34. *Id.*

35. *Id.* § 108(b)(3)(B).

36. *Id.* § 108(b)(3)(A).

37. *Id.* § 108(b)(5)(A).

38. *Id.* § 108(b)(5)(B).

zero, yet debt discharge income remains, attribute reduction is commenced according to the rules discussed above.[39]

In order to prevent the permanent deferral of taxation, which was possible under prior law, the debtor is not allowed to reduce the basis of non-depreciable property.[40] Furthermore, if the debtor elects to reduce the basis of a capital asset, on the disposition of that asset the debtor will recognize ordinary income—not capital gain—to the extent the realized gain is attributable to the basis reduction.[41]

The common law exception to the holding of *Kirby Lumber Co.*, found in *Motor Mart Trust* and *Capento Securities Corp.*,[42] is limited by the Bankruptcy Tax Act. Under the Act the debtor company will recognize income where a creditor receives a de minimis amount of stock in satisfaction of his claim.[43] Additionally, the debtor company will recognize income where an unsecured creditor does not receive at least half the amount of stock he would have received had all unsecured creditors participating in the workout received stock on a prorata basis.[44]

The Bankruptcy Tax Act also creates several new rules as to when

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39. *Id.* § 108(b)(5)(C). This section provides that the loss carryovers and tax credit carryovers do not have to be reduced to the extent the taxpayer elects to reduce asset basis. *Id.* By implication, where asset basis cannot be reduced, the other tax attributes must be reduced.

40. I.R.C. § 107(b)(3). For a discussion how a taxpayer permanently deferred taxes under former sections 108 and 1017, see notes 14-18 *supra.*

41. I.R.C. §§ 1017(d)(1), (2). For a discussion on how a taxpayer converted ordinary income into capital gain under former sections 108 and 1017, see notes 14-18 *supra.*

42. *See* note 21 *supra* for a discussion on *Motor Mart Trust* and *see* note 22 *supra* for a discussion on *Capento Securities Corp.*

43. I.R.C. § 108(e)(8)(A).

44. *Id.* § 108(e)(8)(B). The Senate Report on H.R. 5043 explains the operation of section 108(e)(8)(B) through the following example:

> [I]f creditor A held $1,000 of unsecured debt against a debtor corporation and if, in a workout, the debtor corporation fully satisfied $10,000 of its unsecured debt (including the debt to A) by the transfer of $6,000 of its stock, A must receive at least $300 of stock in satisfaction of its claim (assuming no other property is transferred) in order for the debtor to rely, with respect to the stock issued to A, on the general rule of present law that no debt discharge income is recognized and no attribute reduction is required when a corporation's debt is satisfied by the issuance of its own stock. If creditor A receives only $100 of stock for his $1,000 debt under these facts, then the debtor corporation will have a debt discharge amount of $900 with respect to issuance of stock to creditor A. If creditor A receives $300 or more of stock for his $1,000 debt under these facts, then the debtor corporation will not have any debt discharge amount with respect to issuance of stock to creditor A.

SENATE REPORT ON H.R. 5043, *supra* note 2, at 17. Considerable controversy surrounded the enactment of this provision of the Bankruptcy Tax Act. *See* notes 147-53 *infra.*

debt will be deemed discharged.[45] The Act provides that where debt obligations of a debtor are acquired by a person related to the debtor, the transaction will be treated as if the debtor acquired the debt.[46] While there is no discussion in the legislative history as to the purpose behind this related-party provision, it is apparent that the provision was enacted to prevent the circumvention of the discharge-of-indebtedness rules by family members and related business entities. For example, absent the related party provision, two corporations owned by the same individual could easily circumvent the discharge-of-indebtedness rules by purchasing each other's outstanding debt obligations at a discount. Furthermore, the Act provides that when a shareholder-creditor voluntarily extinguishes his debt claim, the transaction shall be treated as if the corporation had satisfied the shareholder-creditor's claim by distributing to the shareholder an amount of money equal to his adjusted basis in the debt.[47] The contribution to capital rules of section 118 of the Code are made expressly

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45. *See* notes 46-50 *infra* for a discussion on the new debt discharge rules.

46. I.R.C. § 108(e)(4). Under the tax act a "person" is related to the debtor if he bears a relationship to the debtor specified in either section 267(b) or section 707(b) of the Code. *Id.* Section 267(b) provides that the loss on a sale or exchange of property will be disallowed where the sales or exchange takes place between members of a family, between an individual and a corporation 50% owned by that individual, between two corporations each 50% owned by the same individual, between a trust fiduciary and grantor of that trust, and so on. I.R.C. § 267. Section 707(b) provides that the loss on a sale or exchange of property between a partner and his partnership and between two partnerships with common partners, will be disallowed. I.R.C. § 707(b)(1).

The related party rules of the Bankruptcy Tax Act have been criticized for forcing the recognition of debt discharge income in situations where capital contribution or gift treatment would be appropriate. *House Hearings on H.R. 5043*, note 2 *supra*, at 178 (comments of John Jerome of Milbank, Tweed, Hadley & McCloy). For example, where a father purchases at a discount the business debt of his son and then forgives $3,000 worth of debt per year, gift treatment, rather than income recognition, seem more equitable. *Id.*

47. I.R.C. § 108(e)(6). The Senate Report on H.R. 5043 explains the operation of I.R.C. § 108(e)(6) with the following illustration:

> For example, assume a corporation accrues and deducts (but does not actually pay) a $1,000 liability to a shareholder-employee as salary, and the cash-basis employee does not include the $1,000 in income. In a later year, the shareholder-employee forgives the debt.
>
> Under the bill, the corporation must account for a debt discharge amount of $1,000. If the corporation is insolvent or in bankruptcy, it must apply the $1,000 debt discharge amount to reduce tax attributes . . . .
>
> On the other hand, if the shareholder-employee were on an accrual basis, had included the salary in income, and his or her basis in the debt was still $1,000 at the time of the contribution, there would be no debt discharge amount, and no attribute reduction would be required.

SENATE REPORT ON H.R. 5043, *supra* note 2, at n.21.

inapplicable.[48] In making the contribution to capital rules inapplicable, the Act overrules the holding of *Putoma Corp. v. Commissioner*[49] where it was held that an accrual basis corporation, which deducted but never paid interest on a debt owed to a shareholder, did not realize income when the shareholder cancelled the corporation's liability for interest due.[50]

In sum, the Bankruptcy Tax Act substantially alters sections 108 and 1017 of the Code in order to cure defects in the existing law which permitted tax avoidance rather than tax deferral.[51] Furthermore, by

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48. I.R.C. § 108(e)(6).

49. 601 F.2d 734 (5th Cir. 1979). Both the House Report on H.R. 5043 and the Senate Report on H.R. 5043 state that I.R.C. § 108 (e)(6) is intended to reverse the result reached in Putoma Corp. v. Commissioner, 66 T.C. 652 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979). *See* HOUSE REPORT ON H.R. 5043, *supra* note 2, at 15 n.21; SENATE REPORT ON H.R. 5043, *supra* note 2, at 19 n.22.

In *Putoma Corp.* a shareholder bought equipment and then sold it to his closely held company, not for cash, but for interest-bearing notes. 601 F.2d at 741. The shareholder was on a cash basis and the corporation was on the accrual basis. *Id.* The corporation would deduct the accrued interest, but never actually pay the shareholder who, therefore, never had to report the interest as income on his tax return. *Id.* After several years, the shareholder forgave the liability for accrued interest in order to improve the financial condition of the corporation in the eyes of potential creditors. *Id.* at n.9.

On these facts the Service argued that under the tax benefit rule the corporation had realized income to the extent the liability for accrued interest had been cancelled. The tax benefit rule provides that the recovery of an item previously deducted is includible in income in the year of recovery. *Id.* The United States Court of Appeals for the Fifth Circuit held that the tax benefit rule was not applicable because the shareholder had made either a gift to the corporation under section 102 of the Code or a contribution of capital to the corporation under section 118 of the Code. The court of appeals found support for its holding in Helvering v. American Dental Co., 318 U.S. 322 (1943); Reynolds v. Boos, 188 F.2d 322 (8th Cir. 1951); Carroll-McCreary Co. v. Commissioner, 124 F.2d 303 (2d Cir. 1941); Commissioner v. Auto Strop Safety Razor Co., 74 F.2d 226 (2d Cir. 1934).

In *American Dental Co.* an accrual basis corporation owed both interest to noteholders and rent to its landlord. In years prior to 1936 the corporation deducted, but did not pay, the interest and rent due. 318 U.S. 323. In 1937 the noteholders cancelled the interest liability and the landlord cancelled part of the liability for rent due. *Id.* at 324. The Supreme Court held that a gratuitous contribution of capital to the corporation was made by the cancellation of the liabilities for interest and rent due, and thus, the corporation did not realize any income from the cancellation of the debts. *Id.* at 331.

In *Carroll-McCreary Co.* the United States Court of Appeals for the Second Circuit held that where an officer-shareholder of an accural basis corporation forgave the corporation's liability for salary due, no income was realized by the corporation as the transaction was a capital contribution. 124 F.2d at 304.

Similar results were reached in *Reynolds*, 188 F.2d at 322, and Auto Strop Safety Razor Co., 74 F.2d at 226.

50. *See* note 49 *supra* for a discussion on *Putoma Corp.* and related authority.

51. See notes 14-18 and accompanying text *supra* for a discussion on how tax avoidance was achieved under prior law. *See* notes 40-41 and accompanying text *supra* for a discussion on how the Bankruptcy Tax Act cures the defects in prior law which permitted tax avoidance.

mandating the reduction of favorable tax attributes whenever debt is discharged, the Act insures that insolvent corporate debtors do not receive too great a tax benefit from the rule providing for the nonrecognition of income from debt discharge.[52] Finally, by requiring that debt purchases by related parties will result in income recognition,[53] and that a creditor's receipt of a small amount of stock will result in income recognition,[54] the Act prevents the easy circumvention of its rules.

II. THE CORPORATE REORGANIZATION PROVISIONS

Chapter XI of the Bankruptcy Reform Act of 1978 provides a mechanism by which a financially distressed company can restructure its debt obligations and equity interests so that instead of liquidating it can remain in business.[55] A Chapter XI bankruptcy proceeding may take the form of a creditors' reorganization in which the original shareholders of the company are eliminated and the company's creditors substituted in their stead.[56] Alternatively, a Chapter XI

52. *See* notes 31-39 and accompanying text *supra* for a discussion on how the Bankruptcy Tax Act correlates attribute reduction to debt discharge.

53. *See* note 46 and accompanying text *supra* for a discussion on how debt purchases by related parties can result in the recognition of debt discharge income.

54. *See* notes 43 & 44 and accompanying text *supra* for a discussion on the stock-for-debt rules under the Bankruptcy Tax Act.

55. *See, e.g.*, SENATE JUDICIARY COMM., REPORT ON THE BANKRUPTCY REFORM ACT OF 1978, S. REP. NO. 95-989, 95th Cong., 2d Sess. 9 (1978), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5795 ("Chapter 11 deals with the reorganization of a financially distressed business enterprise, providing for its rehabilitation by adjustment of its debt obligations and equity interests"). In a Chapter XI proceeding, the debtor company or its trustee attempts to obtain creditor approval of a plan of reorganization. *See* HOUSE JUDICIARY COMM., REPORT ON THE BANKRUPTCY REFORM ACT OF 1978, H.R. REP. NO. 95-595, 95th Cong., 2d Sess. 219 (1978), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6180 ("[t]he primary purpose of the reorganization is to formulate and have confirmed a plan of reorganization or arrangement for the debtor"). A plan of reorganization "determines how much creditors will be paid, and in what form (cash, property, or securities, for example); whether the stockholders will continue to retain any interest in the company; and in what form the business will continue (without several unprofitable divisions, for example)." *Id.*

56. *See, e.g.*, Helvering v. Cement Investors, Inc., 316 U.S. 527 (1942); Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942); Palm Spring Holding Corp. v. Commissioner, 315 U.S. 185 (1942); Commissioner v. Motor Mart Trust Co., 156 F.2d 122 (1st Cir. 1946); Alexander Duncan v. Commissioner, 9 T.C. 468 (1947), *acq.* 1948-2 C.B. 2; Revenue Ruling 77-81, 1977-1 C.B. 97, for examples of creditors' reorganizations.

In *Alabama Asphaltic Limestone Co.*, the creditors of an insolvent corporation initiated involuntary bankruptcy proceedings for the company. 315 U.S. at 181. There were two classes of creditors: noteholders who were owed approximately $793,000 and general creditors who were owed about $45,000. *Id.* The bankrupt company's assets had an appraised value of $155,000. *Id.* Pursuant to a plan of reorganization a new corporation was created, the assets of the bankrupt company were transferred to the new entity, and the

bankruptcy proceeding may take the form of an acquisitive reorganization in which a solvent corporation acquires an insolvent corporation either by purchase or merger.[57] Prior to the passage of the Bankruptcy Tax Act, the tax consequences flowing from either an acquisitive reorganization or a creditors' reorganization varied substantially depending on whether the reorganization fit within the terms of section 368, section 351, or sections 371-374 of the Code.[58]

Under section 371 of the Code no income was recognized where the assets of the debtor company were transferred to another company pursuant to a court order in a Chapter X proceeding under the former Bankruptcy Act,[59] or in a receivership, foreclosure, or similar pro-

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stock of the new corporation was issued to the noteholders and the general creditors. *Id.* at 182. The stockholders of the original bankrupt company received nothing. *Id.*

The Supreme Court held that a tax-free reorganization had been consummated because the continuity of proprietary interest between the bankrupt company and its successor had not been broken. *Id.* at 184. According to the Supreme Court, the creditors of the bankrupt company were its true equity owners, and thus, their receipt of stock in the new corporation just conformed to true economic realities. *Id.* The creditors of the bankrupt company had "stepped into the shoes of the old stockholders" as of the date the insolvency proceedings commenced. *Id.*

In *Palm Springs Holding Corp.* the Supreme Court reached a result similar to that reached in *Alabama Asphaltic Limestone Co.* In *Palm Springs Holding Corp.* the creditors of an insolvent company initiated a foreclosure proceeding, transferred the assets of the insolvent corporation to a newly formed corporation at the foreclosure sale, and received most of the stock in the newly formed company. The old shareholders were eliminated. 315 U.S. at 186-87. On the basis of these facts, the Supreme Court held that a tax-free reorganization had taken place, expressly relying on the rationale set forth in *Alabama Asphaltic Limestone Co. Id.* at 189.

For a discussion on *Motor Mart Trust Co.*, see note 21 *supra*. For a discussion on *Alexander Duncan v. Commissioner, Revenue Ruling 77-81*, and *Helvering v. Cement Investors*, see notes 104-07 *infra*.

57. *See, e.g.*, Revenue Ruling 59-222, 1959-1 C.B. 80, for an example of an acquisitive reorganization. For an excellent discussion on acquisitive reorganizations in the bankruptcy context, see Tillinghast & Gardner, *Acquisitive Reorganization and Chapters X and XI of the Bankruptcy Act*, 26 TAX L. REV. 663, 672-86 (1971) [hereinafter cited as Tillinghast & Gardner].

58. *See* notes 59-107 and accompanying text *infra* for a discussion on sections 371, 368, and 351 of the Code.

59. Prior to the Bankruptcy Reform Act of 1978, an insolvent corporation could seek to be financially rehabilitated under either Chapter X or Chapter XI of the old Bankruptcy Act. *See* 124 CONG. REC. S17,406 (daily ed. October 6, 1978), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6505, at 6535 (statement of Sen. DeConcini). Under Chapter X a trustee was appointed to manage the debtor's assets and the plan of reorganization could affect the interests of unsecured creditors, secured creditors, and of equity holders. *See* [1978] U.S. CODE CONG. & AD. NEWS 6535, where Senator DeConcini states that two of the essential elements of a Chapter X proceeding are "that, first, an independent trustee be appointed and assume management control from the officers and directors of the debtor corporation" and that "the court has the power to affect, and grant the debtor a discharge in respect of, all types of claims, whether secured or unsecured." In a Chapter XI the cor-

ceeding, and the security-holders of the debtor company received stock or securities only from the corporation to which the debtor company had transferred its assets.[60] Section 372 provided for the carryover of asset basis in transactions to which Code section 371 applied.[61] Sections 373-374 concerned railroad reorganizations.[62]

The first major drawback embodied in Code section 371 was that a corporate debtor did not have flexibilty in structuring its insolvency reorganization in that the reorganization could not take the form of a triangular merger.[63] In a triangular merger the assets of the debtor company are transferred to a subsidiary of the acquiring corporation in exchange for the receipt of stock or securities from the acquiring corporation.[64] The primary advantage of a triangular merger is that the acquiring corporation does not have to assume the insolvent company's liabilities, which can be hidden and often substantial, since the subsidiary, in the technical sense, is considered the acquirer.[65]

The second major drawback in attempting to structure an insolvency proceeding so that it came within the terms of section 371 of the Code was that it was unclear whether the favorable tax attributes of the in-

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poration retained control over its assets, but the plan of reorganization could affect only the interests of the unsecured creditors. *See also* [1978] U.S. CODE CONG. & AD. NEWS 6538, in which Senator DeConcini states that Chapter XI offered "the corporate debtor ... continuity of management" but did not permit the debtor to "'affect' secured creditors or shareholders, in the absence of their consent." The differences between Chapter X and Chapter XI are probably due to the fact that "Chapter X was designed to facilitate the pervasive reorganization of corporations whose creditors include holders of publicly issued debt securities," while "Chapter XI, on the other hand, was designed to permit smaller enterprises to negotiate composition or extension plans with unsecured creditors." *Id.* at 6535.

For good discussions of the differences between Chapter X and Chapter XI proceedings under the old Bankruptcy Act, see A. COHEN, DEBTOR-CREDITOR RELATIONS UNDER THE BANKRUPTCY ACT OF 1978, at 720-21 (1979); Tillinghast & Gardner, *supra* note 57, at 665-67.

60. I.R.C. § 371.

61. *Id.* § 372.

62. *Id.* §§ 373-374.

63. *Accord*, HOUSE REPORT ON H.R. 5043, *supra* note 2, at 28; SENATE REPORT ON H.R. 5043, *supra* note 2, at 33; Part I of the Bankruptcy Commission Report, *supra* note 2, at 304-06. The Bankruptcy Commission Report provides that "present law results in irrational distinctions between economically similar forms of insolvency reorganization, and thus restricts the flexibility of the parties and the bankruptcy courts in adjusting plans to nontax needs." *Id.* at 285. The House Report provides: "[The] special rules for insolvency reorganizations generally allow less flexibility in structuring tax-free transactions than the rules applicable to corporate reorganizations as defined in Section 368 of the Code." HOUSE REPORT ON H.R. 5043, *supra* note 2, at 33. *See* notes 84-100 and accompanying text *infra* for a discussion on section 368 of the Code.

64. *See* Ferguson & Ginsburg, *Triangular Reorganizations*, 28 TAX L. REV. 159 (1973), for an in-depth discussion on triangular mergers.

65. *See generally id.* at 160.

solvent company carried over to the asset acquiring company.[66] Before the Bankruptcy Tax Act was enacted, section 381 of the Code provided that a corporation which acquires another company may assume that company's tax attributes, provided the acquisition takes the form of certain transactions described in section 368.[67] Because section 381 did not include insolvency reorganizations undertaken pursuant to section 371 as one of the specified types of transaction in which tax attributes carried over, taxpayers had to argue that, under the common law of taxation, favorable tax attributes survived bankruptcy proceedings.[68] However, under the common law of taxation it was unclear whether pre-bankruptcy NOL's could offset post-bankruptcy income,[69] and

66. *See* HOUSE REPORT ON H.R. 5043, *supra* note 2, at 28, which provides: "the special rules for insolvency reorganizations do not permit carryover of tax attributes to the transferee corporation. . . ."

67. I.R.C. § 381.

68. *See* notes 69-82 and accompanying text *infra* for a discussion on the case law dealing with the carryover of tax attributes in insolvency reorganizations.

69. *Compare* Huyler's v. Commissioner, 327 F.2d 767 (7th Cir. 1964); Willingham v. United States, 289 F.2d 283 (5th Cir. 1961); and Wisconsin Cent. R.R. v. United States, 296 F.2d 750 (Ct. Cl. 1969) *with* United States v. Adkins-Phelps, Inc., 400 F.2d 737 (8th Cir. 1968); Daytona Beach Kennel Club, Inc. v. Commissioner, 69 T.C. 1015 (1978); *and* Jacqueline, Inc., 36 T.C.M. 1363 (CCH) (1977).

In *Huyler's* a corporation which operated restaurants and made candy entered into Chapter X proceedings under the old Bankruptcy Act. For a discussion on Chapter X bankruptcy proceedings, see notes and accompanying text *supra*. In the Chapter X reorganization the corporation's old stockholders were eliminated, its creditors received 52% of a new issue of common stock and the remainder of the stock went to three new investors who contributed $250,000 in cash. The corporation also terminated its restaurant and candy-making business and bought a metal manufacturing business, which proved to be highly profitable. The corporation then tried to offset its post-bankruptcy profits with its pre-bankruptcy NOLs.

The United States Court of Appeals for the Seventh Circuit held that the corporation was not able to use the pre-bankruptcy NOL's to offset its post-bankruptcy income. 327 F.2d at 772. According to the court, the taxpayer that generates the NOL's must be the taxpayer to utilize the NOL's, and in this case it could not be said that the pre-bankruptcy and post-bankruptcy corporation were one and the same. *Id.* The court found that there had been such a substantial change in the business operations and in the ownership interests that the pre-bankruptcy corporation was an entirely different entity from the post-bankruptcy corporation. *Id.* at 773.

In *Willingham* a trucking firm was reorganized under the old bankruptcy act. While in bankruptcy reorganization proceedings the old shareholders were eliminated, a new investor substituted in their stead, and all of the debts of the company were wiped out.

In a tax evasion proceeding, the new owner of the company argued he could not be prosecuted for failing to report the trucking firm's income because the post-reorganization income of the company was completely eliminated by the carryforward of pre-reorganization NOL's. 289 F.2d at 284-85. The United States Court of Appeals for the Fifth Circuit dismissed the taxpayer's argument, stating that under the law only the taxpayer which generated the NOL's could use the NOL's and that in this case the post-reorganization company could not be said to be the same taxpayer as the pre-reorganization company. *Id.* at 287.

In *Wisconsin Central Railroad* a bankrupt railroad company (the Predecessor) transferred all of its assets to a newly formed corporation. The newly formed corporation assumed the bonded indebtedness of the Predecessor by issuing both bonds and stock to the bondholders of the Predecessor, but the unsecured creditors and stockholders of the Predecessor receiving nothing. The new corporation generated an NOL in its first year of existence and sought to obtain a tax refund by carrying back the NOL and offsetting the pre-bankruptcy income of the Predecessor. The Court of Claims did not permit the NOL carryback, stating:

> In this reorganization the old stockholders were wiped out; they were no longer in business; the new stockholders were some of the former creditors of the business. The same business was being carried on, but by a different group of people. Thus, continuing ownership is not present, and hence, the successor corporation cannot carryback its losses to offset gain realized by the old corporation.

296 F.2d at 757.

In *Daytona Beach Kennel Club* a profitable corporation acquired another corporation which, at the time, was in a Chapter X insolvency proceeding. *See* notes 58-60 and accompanying text *supra* for a discussion on Chapter X proceedings. The profitable corporation then offset its income with the NOL's generated by the insolvent corporation prior to and during its Chapter X bankruptcy reorganization. The Service disallowed the carryover of the NOL's, relying on section 269 of the Code which prohibits NOL carryovers where an acquisition is made for the purpose of avoiding taxes. The Service expressly conceded that the NOL carryover would not be barred by section 382 of the Code. *See* note 94 *infra* for a discussion on section 382. The Tax Court held that section 269 of the Code did not apply because the acquisition was made for a valid business reason and not for the purpose of tax avoidance. 69 T.C. at 1032. The Tax Court also held that *Willingham* was no longer viable as controlling precedent. *Id.* at 1034. According to the Tax Court, a corporation's NOL may carryover to another company unless the carryover is limited by section 381 or 382. Since the Service had expressly conceded that section 382 did not apply, the NOL could carryover.

In *Adkins-Phelps* a profitable corporation had acquired another corporation which had undergone state receivership proceedings. The principal stockholder of the insolvent corporation received a one-sixth interest in the acquiring corporation and the old business of the insolvent corporation was continued. On these facts the United States Court of Appeals for the Eighth Circuit held that the acquiring company could offset its income with NOL's generated by the insolvent company prior to its acquisition.

In *Jacqueline, Inc.* a corporation which owned and operated hotels entered into Chapter X insolvency proceedings. While in insolvency proceedings, a new group of shareholders were substituted for the original shareholders and the debts of the corporation were cancelled. After emerging from Chapter X proceedings, the corporation became very profitable. The corporation attempted to shelter its post-bankruptcy income by carrying forward its pre-bankruptcy lossess. Relying on *Willingham*, the Service disallowed the NOL deduction, stating that the post-bankruptcy corporation was not the same taxpayer as the pre-bankruptcy corporation. The Tax Court disagreed with the Service, stating: "[I]n our opinion [the corporation], after the Chapter X reorganization, was the same entity as before the reorganization. Although a different stock ownership and management group controlled the corporation after the reorganization . . . , the same business enterprise continued." 36 T.C.M. at 1371. Accordingly, the Tax Court held that the corporation was entitled to shelter its post-bankruptcy income by carrying forward its pre-bankruptcy losses. *Id.*

For some good discussions on this general area of the law, see Gaffney, *Net Operating Losses, Basis and Other Tax Attributes of Corporations in Bankruptcy and Insolvency*, 34 N.Y. INST. FED. TAX. 479 (1976); Plumb, *The Tax Recommendations of the Commission on the Bankruptcy Laws—Reorganization, Carryovers and the Effect of Debt Cancellation*, 29 TAX L. REV. 229 (1974).

whether an earnings and profit deficit generated prior to bankruptcy could shelter from taxation corporate distributions made to shareholders after bankruptcy.[70]

The early cases of *Huyler's v. Commissioner*[71] and *Willingham v. United States*[72] held that corporate taxpayers could not offset post-bankruptcy income with NOL's generated prior to bankruptcy. Similarly, in *Wisconsin Central Railroad v. United States*[73] it was held that a post-bankruptcy NOL could not be carried back to offset pre-bankruptcy income. On the other hand, the later cases of *United States v. Adkins-Phelps, Inc.*,[74] *Daytona Beach Kennel Club v. Commissioner*,[75] and *Jacqueline, Inc. v. Commissioner*,[76] held that post-bankruptcy profits could be sheltered from taxation by pre-bankruptcy NOL's. Although the Service appeared to shift its position in a letter ruling,[77] any plan of reorganization dependent on the utilization of a pre-bankruptcy NOL was subject to a high degree of risk.

With respect to earnings and profits, the Service had ruled in *Revenue Ruling 75-515*[78] that a deficit in a corporation's earnings and

70. *Compare* Meyer v. United States, 383 F.2d 883 (8th Cir. 1967) *with* United States v. Kavanagh, 308 F.2d 824 (8th Cir. 1961). In *Meyer* a corporation entered into Chapter XI proceedings under the old Bankruptcy Act. *See* note 59 and accompanying text *supra* for a discussion on Chapter XI. While in Chapter XI, $189,785 of the corporation's debt was cancelled. Subsequently the Service argued that the debt cancellation resulted in positive earnings and profits for the corporation, and thus distributions to the corporation's shareholders should be deemed dividends. The United States Court of Appeals for the Eighth Circuit disagreed, holding that "the adjustment of the corporation's debts . . . did not result in the creation of earnings and profits for the corporation, with the dividend consequences which would otherwise ensue." 383 F.2d at 889. In *Kavanagh* it was held that a corporation which emerged from an insolvency reorganization "started out with a new financial slate," and, thus, since the corporation had income subsequent to the insolvency reorganization, distributions to its shareholders qualified as dividends. 308 F.2d at 830-32.

The term "earnings and profits" is defined in I.R.C. § 312. A deficit in a corporation's earnings and profits account constitutes a favorable tax attribute because, if a corporation does not have positive earnings and profits, then all distributions to its shareholders are deemed returns of capital rather than dividends. I.R.C. § 316. Dividends are taxable as ordinary income. I.R.C. § 301(c). But returns of capital do not constitute taxable income.

71. 327 F.2d 767 (7th Cir. 1964). *See* note 69 *supra* for a discussion of *Huyler's*.

72. 289 F.2d 283 (5th Cir. 1961). *See* note 69 *supra* for a discussion of *Willingham*.

73. 296 F.2d 750 (Ct. Cl. 1961). *See* note 69 *supra* for a discussion of *Wisconsin Central Railroad*.

74. 400 F.2d 737 (8th Cir. 1968). *See* note 69 *supra* for a discussion of *Adkins-Phelps, Inc.*

75. 69 T.C. 1015 (1978). *See* note 69 *supra* for a discussion of *Daytona Beach Kennel Club, Inc.*

76. 36 T.C. Memo 1015 (1978). For a discussion of *Jacqueline, Inc.*, see note 69 *supra*.

77. Private Ruling 7953017 (Sept. 27, 1979).

78. 1975-2 C.B. 117. In Revenue Ruling 75-515 the Service found that while a corporation does not recognize income from the cancellation of its debts in a Chapter XI insolven-

profits account is reduced by the amount of debt cancelled in Chapter XI insolvency proceedings.[79] Support for the Service's position can be found in *United States v. Kavanagh*.[80] However, in *Meyer v. United States*[81] it was held that a deficit in a corporation's earnings and profits account did survive a bankruptcy proceeding under Chapter XI of the former Bankruptcy Act.[82]

Because of the drawbacks contained in sections 371-374, insolvent corporate taxpayers often attempted to structure their bankruptcy reorganization so that it qualified under section 368 or section 351 of the Code.[83]

Section 368 describes certain mergers or acquisitions in which no income need be recognized at the corporate level, shareholder level, or security-holder level.[84] Prior to the passage of the Bankruptcy Tax Act, section 368 enumerated six types of mergers or acquisitions, referred to as reorganizations, which could qualify for tax-free treatment. An "A" reorganization is a merger effectuated according to state law.[85] An "A" reorganization is the most flexible reorganization since it can take the form of a triangular merger, a reverse triangular merger, or a merger followed by a transfer of the acquired company's assets to a controlled subsidiary.[86] A "B" reorganization is consumated where eighty percent of the stock of the acquired company is surrendered *solely* for the voting stock of the acquiring company or its parent.[87] A "C" reorganization involves acquiring substantially all of the assets of the acquired company in exchange for the stock of the acquiring com-

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cy proceeding, it does derive an economic benefit to the extent of such cancellation. Thus, the Service held that the earnings and profits account of the corporation should be adjusted upward to reflect the receipt of this economic benefit.

79. *See* note 59 *supra* for a discussion of Chapter XI insolvency proceedings under the old Bankruptcy Act.

80. 308 F.2d 824 (8th Cir. 1962). *See* note 70 *supra* for a discussion of *Kavanagh*.

81. 383 F.2d 883 (8th Cir. 1967). *See* note 70 *supra* for a discussion of *Meyer*.

82. *See* note 59 *supra* for a discussion of Chapter XI proceedings under the old Bankruptcy Act.

83. *See* Revenue Ruling 59-222, 159-1 C.B. 80 for an example of a corporate bankruptcy proceeding taking the form of a reorganization under section 368 of the Code. *See* notes 84-100 *infra*. *See* Revenue Ruling 77-81, 1977-1 C.B. 97, for an example of an insolvency proceeding structured to take advantage of Code section 351. *See* notes 101-07 and accompanying text *infra* for a discussion of section 351.

84. *Accord*, Tillinghast & Gardner, *supra* note 57, at 698-704.

85. I.R.C. § 368(a)(1)(A). For a good discussion on "A" reorganizations, see Vrooman, *Corporate Acquisitions—(A) Reorganizations*, Tax Management Portfolios 77-3d (1974) [hereinafter cited as Vrooman].

86. I.R.C. §§ 368(a)(2)(C), (D), (E). For a discussion on triangular mergers, reverse triangular mergers, and asset dropdowns, see Vrooman, *supra* note 85, at A-3 to A-8.

87. I.R.C. § 368(a)(1)(B). *See* Vrooman, *Corporate Acquisitions—(B) Reorganizations*, Tax Management Portfolios 78-3d (1979).

pany or its parent.[88] A corporation undergoes a "D" reorganization when it is divided into its component parts.[89] A recapitalization constitutes a "E" reorganization.[90] An "F" reorganization is merely a change in form or identity.[91]

Under the prior law, corporate bankruptcy proceedings were accorded tax-free treatment under section 368. For example, in *Revenue Ruling 59-222*[92] it was held that a Chapter X insolvency proceeding under the old Bankruptcy Act[93] qualified as a "B" reorganization under section 368. However, because of two major statutory defects, adverse tax consequences often could flow from structuring a corporate bankruptcy proceeding as a section 368 reorganization. First, when an insolvency reorganization came within the terms of section 368, section 382 severely limited the availability of the NOL carryover.[94] Second,

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88. I.R.C. § 368(a)(1)(C). *See* Vrooman, *Corporate Acquisitions—(C) Reorganizations*, Tax Management Portfolios 79-2d (1980).

89. I.R.C. § 368(a)(1)(D). *See* Phillips, *Corporate Acquisitions—(D) Reorganizations*, Tax Management Portfolios 417 (1981).

90. I.R.C. § 368(a)(1)(E). *See* Horwood & Hindin, *Corporate Recapitalizations*, Tax Management Portfolios 52-2d (1974).

91. I.R.C. § 368(a)(1)(F). *See* Phillips, *Corporate Acquisitions—(F) Reorganizations*, Tax Management Portfolios 128-2d (1980).

92. 1959-1 C.B. 80. In *Revenue Ruling 59-222*, a corporation undergoing a Chapter X insolvency proceeding, which we shall call "B Corporation" had the following liabilities: (1) first mortgage bonds with a face value of $6,000x and paying 4½% interest per annum, (2) subordinated debentures with a face value of $7300x and paying 6% interest per annum, (3) a bank loan of $250x, and (4) general unsecured claims of $1100x. The company had a negative net worth of $4000x. Another company, which shall be called "A Corporation," acquired the bankrupt company, the acquisition taking the following form: (1) A Corporation issued some of its stock to B Corporation in exchange for all of the common stock of B Corporation. As a result the old shareholders of B Corporation were eliminated and B Corporation became a subsidiary of A Corporation; (2) B Corporation then distributed the A Corporation stock it had received to its general unsecured creditors and its debenture holders; (3) the bank loan was paid in cash and the bond liability remained outstanding.

On these facts the Service held that the acquisition "constitutes a reorganization within the meaning of Section 368(a)(1)(B) of the Code." 1959-1 C.B. at 82. In other words, the transaction constituted a "B" reorganization. (For a definition of the term "B" reorganization, see the text accompanying note 87 *supra*.) The Service reasoned that the debenture holders and unsecured creditors of the bankrupt company were the true equity owners of the company, and thus the transaction should be viewed as if the debenture holders and unsecured creditors had surrendered their claims in exchange for the new issue of B Company stock and then exchanged such stock for the stock of A Corporation.

93. *See* note 59, *supra* for a discussion of Chapter X proceedings under the old Bankruptcy Act.

94. I.R.C. § 382 (amended 1976). Section 382(a) of the Code provides that a corporation's NOL carryovers are extinguished where, within a two year period any one or more of the ten largest shareholders of the loss corporation increase their ownership interest by 50 percentage points or more by "purchase," and the corporation ceases to conduct the business it conducted prior to the change of ownership. *Id.* Section 382(b) of the Code pro-

because of sections 354 and 355 of the Code, short-term creditors had to recognize income when they received stock in exchange for the release of their claims.[95]

Under sections 354 and 355, creditors who possessed "securities" did not recognize income in a section 368 reorganization where they exchanged their securities for stock for other securities of an equal principal amount.[96] However, Code sections 354 and 355 do not provide for

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vides for the reduction of a corporation's NOL carryover where, as a result of a reorganization, its shareholders do not receive at least 20% of the stock of the surviving corporation. *Id.* For each percentage point that the original shareholders' interest is below 20%, the NOL is reduced by 5%. *Id.*

Section 382 of the Code was substantially changed by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 806(e), 90 Stat. 1520. However, the amendments to section 382 will not go into effect until 1982. For a discussion of section 382 and its amendments under the Tax Reform Act of 1976, see Anderson, *The Tax Reform Act of 1976: Net Operating Losses*, 29 S. CAL. TAX INST. 111 (1977); Committee on Corporations of the Tax Section of the New York Bar Association, *Report on Section 382 of the Internal Revenue Code as Amended by the Tax Reform Act of 1976*, 31 TAX LAW. 283 (1977); Eustice, *The Tax Reform Act of 1976: Loss Carryovers and Other Corporate Changes*, 32 TAX L. REV. 113 (1977).

95. *Accord*, Tillinghast & Gardner, *supra* note 57, at 698-704. Tillinghast & Gardner state:

> Even where they receive stock or securities of in exchange for their claims, creditors of the distressed corporation who are not considered security holders must recognize gain or loss on the exchange. Although the requirement that a creditor rise to the level of a security holder, as opposed to some other form of creditor, in order to obtain nonrecognition treatment has been subjected to substantial criticism, both the decided cases and the Service impose this requirement. Therefore, the creditor on open account, the commercial paper holder, the short-term note holder or demand note holder will recognize gain or loss when he exchanges that right for stock or securities in the acquiring corporation.

Id. at 699.

The cases support the proposition that under section 354 of the Code, short-term creditors must recognize income on the exchange of stock-for-debt. *See, e.g.*, Neville Coke & Chem. Co. v. Commissioner, 148 F.2d 599 (3d Cir. 1945), in which it was held that noteholders of a reorganized corporation, who exchanged their notes for debentures and common stock, could not claim non-recognition of their gain under what is now section 354 of the Code. *See also* F.T. Bedford, 2 T.C. 1189, *aff'd*, 150 F.2d 341 (2d Cir. 1945); Bunker Hill & Sullivan Mining & Mfg. Co., 1 T.C. 1057, 1079-80 (1943).

96. I.R.C. §§ 354, 355. For the purposes of the Code a "security" is a long-term debt-instrument. *See* Griswold, *"Securities" and "Continuity of Interest,"* 58 HARV. L. REV. 705 (1945); Comment, *Section 351 Transfers to Controlled Corporations: The Forgotten Term—"Securities,"* 114 U. PA. L. REV. 314 (1965), for discussions on the term "security." Because securities are defined, basically, as long-term debt instruments, short-term notes and trade credit do not qualify as securities. *Id.* Furthermore, because securities are long-term debt instruments, the line between securities and stock is thin; thus, the Service recently issued regulations to help delineate between debt and equity. *See* Treas. Reg. §§ 1.385-1 to -10 (1981). For a good discussion on the debt-equity regulations, see Beghe, *An Interim Report on the Debt-Equity Regulations Under Code Section 385*, 59 TAXES 203 (1981).

the non-recognition of income where creditors release claims not represented by "securities" in exchange for receiving stock or securities. Consequently, short-term creditors recognized income when they released their claims in consideration for the receipt of stock or securities.[97]

Section 382 of the Code provides for the extinguishment of NOL carryovers in two situations. Under section 382(a), NOL carryovers are extinguished where: (1) within a two year period any one of the ten largest shareholders of the loss corporation increases by "purchase," his ownership share by fifty percentage points or more, and (2) the corporation discontinues its historic business after the change in ownership.[98] Under section 382(b), the NOL carryovers are reduced pursuant to a statutory formula whenever, as a result of a merger or acquisition, the original shareholders of the loss corporation do not retain at least a twenty percent equity interest in the successor corporation.[99] Obviously, section 382(b) precludes the carryover of NOLs in many corporate bankruptcy proceedings because in many such instances the original shareholders are eliminated.[100]

Because of the drawbacks inherent in structuring a corporate bankruptcy proceeding so that it came within sections 371 or 368, prior to the Bankruptcy Tax Act some taxpayers utilized section 351 of the Code.[101] Under section 351 no income is recognized where one or more persons transfer property to a corporation in exchange for stock constituting control of the corporation.[102] Prior to the passage of the Bankruptcy Tax Act, the release of unsecured debt was deemed to be a transfer of property within the meaning of section 351.[103] In *Alex-*

97. *See* note 95 *supra* for a brief discussion of the cases which hold that short-term creditors must recognize income where they exchange their claims for stock.

98. I.R.C. § 382(a). *See* note 94 *supra.*

99. I.R.C. § 382(b). *See* note 94 *supra.*

100. *See* note 56 *supra* for a discussion of cases in which the original shareholders of an insolvent company were eliminated completely during insolvency proceedings.

101. *See* Revenue Ruling 77-81, 1977-1 C.B. 97, for an example of a bankruptcy reorganization being structured to take advantage of section 351 of the Code. For an in-depth discussion on *Revenue Ruling 77-81*, see note 106 and accompanying text *infra.*

102. I.R.C. § 351 (amended 1980). Prior to the passage of the Bankruptcy Tax Act, section 351 provided that no income would be recognized where one or more persons transferred property to a corporation in exchange for stock constituting "control" of that corporation. *Id.* Section 368(c) of the Code defines "control" as possession of at least 80% of the voting stock of a corporation and the possession of at least 80% of the total number of shares of the corporation. I.R.C. § 368(c).

103. *See* Helvering v. Cement Investors, Inc., 316 U.S. 527 (1941) (per curiam); Alexander E. Duncan v. Commissioner, 9 T.C. 468 (1947), *acq.*, 1948-2 C.B. 2; Revenue Ruling 77-81, 1977-1 C.B. 97.

In *Cement Investors* the Supreme Court held that the predecessor to section 351 applied to the surrender of bonds by security holders where the assets of a corporation

ander Duncan v. Commissioner[104] it was held that where judgment creditors of an insolvent corporation acquired over eighty percent of the stock of that corporation in exchange for the relinquishment of their claims, no gain or loss need be recognized as the transaction qualified for tax-free treatment under the statutory predecessor to section 351. Thus, under section 351 unsecured creditors did not have to recognize income when they released their claims in exchange for stock constituting control of the debtor company. Of course this result contrasts sharply with the result reached under section 368.[105]

Furthermore, under prior law there was one other advantage to structuring an insolvency proceeding so that it qualified as a section 351 transaction rather than a section 368 reorganization. Under *Revenue Ruling 77-81*[106] stock was not deemed to be "purchased" for

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were transferred in an insolvency proceeding to another corporation, and stock and bonds of the transferee corporation were issued to the security holders in exchange for the surrender of their bonds of the transferor.

In *Alexander E. Duncan* a corporation owed $270,000 to holders of promissory notes. 9 T.C. at 469. Unable to obtain payment, the noteholders obtained a judgment for $270,000 against the corporation. *Id.* Thereafter it was determined that the corporation should issue 270,000 shares of stock to the noteholders *qua* judgment creditors in exchange for the release of their claims. *Id.* After the recapitalization, the creditors owned 81.84% of the stock of the corporation. The issue before the court was whether the transaction should be accorded nonrecognition treatment under section 112(b)(5) of the 1939 Code. *Id.* at 469-70. Section 112(b)(5) is the predecessor of section 351 of the Code and provided: "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation . . . ." I.R.C. § 112(b)(5) (current version found at I.R.C. § 351). The Service argued that the cancellation of debt did not constitute an exchange of property within the meaning of I.R.C. § 112(b)(5). *Id.* at 470. The Tax Court found otherwise, stating, "The notes and the judgments obtained thereon constituted property in the hands of the petitioners." *Id.* Thus, the court held that the surrender of the judgment claims to the corporation in consideration of the issuance of stock which gave the judgment creditors control of the corporation qualified as an exchange within the meaning of section 112(b)(5) of the 1939 Code. *Id.* at 472. For a discussion on *Revenue Ruling 77-81*, *see* note 106 and accompanying text *infra*.

104. 9 T.C. 468 (1947), *acq.*, 1948-2 C.B. 2. *See* note 103 *supra* for an in-depth discussion on *Alexander Duncan v. Commissioner*.

105. *See* notes 95-97 *supra* for a discussion on the results reached where an insolvency reorganization is structured as a section 368 transaction.

106. 1977-1 C.B. 97. In *Revenue Ruling 77-81* the trade creditors of a corporation undergoing Chapter X insolvency proceedings received 85% of the corporation's voting stock, the old preferred shareholders received 15% of the corporation's voting stock, and the old common shareholders were eliminated. The issue presented the Service was whether the exchange between the bankrupt company and its creditors qualified as a tax-free exchange pursuant to section 351 of the Code so that the creditors would not be deemed to have "purchased" their share within the meaning of section 382(a) of the Code, "purchase" having been defined by the Service as any acquisition of shares through a *taxable* exchange.

Expressly relying on *Alexander E. Duncan*, *see* note 85 *supra*, the Service ruled that

the purposes of section 382(a) of the Code where the controlling block of stock of a corporation was received in exchange for the relinquishment of unsecured claims. Thus, if the corporate bankruptcy proceeding qualified as a section 351 transaction, the NOL's of the company were not destroyed by the operation of section 382(a).[107]

The Bankruptcy Tax Act repeals Code sections 371-374, and in their stead adds the new category of "G" reorganizations to section 368. New section 368(a)(1)(G) provides that if a corporation is undergoing insolvency proceedings, it may transfer all or part of its assets to another company without recognizing any income on the transfer, but only if the asset-acquiring corporation distributes its stock or securities in a manner which comports with section 354, 355, or 356 of the Code.[108] The new "G" reorganization, like the "A" reorganization, can take the form of a triangular merger, reverse triangular merger, or an acquisition followed by a transfer of the acquired assets to a controlled subsidiary.[109]

The Act alters sections 354 and 355 of the Code very slightly. Under the Act short-term creditors still have to recognize income in a "G" reorganization where they release their debts in exchange for stock or securities.[110] However, under the Act long-term creditors whose debts are evidenced by "securities" also must recognize gain where they receive stock or securities in payment of interest accrued on their claims.[111] This alteration of Code sections 354 and 355 reverses *Commissioner v. Carman*,[112] a case in which the United States Court of Appeals for the Second Circuit held that when debt is exchanged for stock, a creditor did not have to recognize income even where the stock was received in payment of interest accrued on the creditor's claim.

The Bankruptcy Tax Act amends section 381 of the Code to cure the ambiguities inherent in prior law as to the carryover of tax attributes

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the issuance of common stock to trade creditors, in exchange for the extinguishment of their claims, is an exchange subject to section 351 of the Code. Because section 351 of the Code applied, the stock was not deemed to be "purchased"; thus, the Service ruled that the net operating loss carryovers of the corporation were not eliminated by the operation of section 382. 1977-1 C.B. at 97.

For a discussion of 382 of the Code, see note 94 and accompanying text *supra*. For a discussion of section 351, see note 102 *supra*. For a discussion on what constitutes a Chapter X insolvency proceeding, see note 59 *supra*.

107. 1977-1 C.B. at 98.

108. I.R.C. § 368(a)(1)(G).

109. *Id.* §§ 368(a)(2)(C), (D). For a discussion of "A" reorganizations, see notes 85-86 and accompanying text *supra*.

110. *Id.* §§ 354, 355.

111. *Id.* § 354(a)(2)(B).

112. 189 F.2d 363 (2d Cir. 1951).

in insolvency reorganizations.[113] Section 381 now provides that in a "G" reorganization the tax attributes of the debtor company carryover to the successor company.[114]

In line with the amendment to section 381, section 382(b) of the Code is amended in order to facilitate the carryover of NOL's in corporate bankruptcy proceedings.[115] New section 382(b) provides that all creditors of the acquired company who receive stock in the successor company, shall be deemed to be among the former owners of the acquired company for purposes of determining whether the former owners received a twenty percent proprietary interest in the acquiring corporation.[116]

Similarly, the Act provides that a deficit in an insolvent company's earnings and profit account will not be reduced by the amount of debt discharged, provided asset basis is reduced,[117] thereby allowing the carryover of the deficit in a "G" reorganization. However, if any shareholers of the acquired company are eliminated, then the deficit in earnings and profits is reduced by an amount equal to the eliminated shareholders' capital contribution.[118]

Finally, the Act amends section 351 of the Code to provide that the relinquishment of debt obligations by unsecured creditors of a company, in exchange for eighty percent of the stock of that company, will not qualify for tax-free treatment.[119] This amendment eliminates an incongruity in the prior law, discussed previously, wherein if a similar transaction occurred under section 368 of the Code, the unsecured creditors would have to recognize income on the exchange.[120]

To summarize, the Bankruptcy Tax Act has introduced significant changes to the Code regarding the tax consequences flowing from corporate bankruptcy proceedings. Under prior law, when a corporation underwent bankruptcy proceedings there were three ways in which the corporation could be financially restructured without the corporation, its creditors, or its shareholders having to recognize gain or loss. Depending on its form, a bankruptcy reorganization could receive tax-

113. *See* notes 66-82 and accompanying text *supra* for a discussion on the ambiguities inherent in the prior law on the carryover of favorable tax attributes.

114. I.R.C. § 381(a).

115. *Id.* § 382(b)(7). For a discussion on what section 382 of the Code provided prior to the passage of the Bankruptcy Act, see note 94 *supra.*

116. *Id.*

117. I.R.C. § 312(1).

118. *Id.* § 312(1)(2).

119. *Id.* §§ 351(1)(d), (e).

120. *See* notes 101-05 and accompanying text *supra* for a discussion on what section 351 of the Code provided prior to the Bankruptcy Tax Act.

free treatment under sections 351, 368, or 371 of the Code.[121] The Bankruptcy Tax Act changes and simplifies prior law by providing that no income need be recognized in a bankruptcy proceeding only if the proceeding qualifies under a modified version of section 368.[122] Furthermore, the Act eliminates an extremely nebulous area of the prior law by providing for the carryover of corporate tax attributes in bankruptcy proceedings.[123] Finally, the Bankruptcy Tax Act introduces some new rules as to when income will be recognized on the exchange of debt for stock, but for the most part preserves the general rule of non-recognition, at least where debt securities are exchanged for an equity interest.[124]

III. MISCELLANEOUS PROVISIONS

Under sections 331 and 337 of the Code, if a corporation adopts a plan of liquidation it may sell its assets and distribute the sale proceeds to its stockholders without recognizing any gain or loss, provided that the liquidation is completed within twelve months of the plan's adoption.[125] In *Revenue Ruling 56-387*[126] and *Revenue Ruling 73-264*[127] the Service ruled that a bankrupt corporation undergoing a twelve month liquidation had to recognize gain or loss on the sale of its assets where the sale proceeds were transferred, not to its shareholders, but to its creditors. The Bankruptcy Tax Act rejects the Service's position, amending section 337 so that it now provides that a bankrupt corpora-

121. *See* notes 59-107 and accompanying text *supra* on the different tax consequences which could result depending on whether a corporate bankruptcy proceeding was structured to fit within I.R.C. § 351, § 368, or § 371.

122. *See* notes 108-09 and accompanying text *supra* for a discussion on the modifications to section 368 of the Code made by the Bankruptcy Tax Act.

123. *See* notes 113-18 and accompanying text *supra* for a discussion on how the Bankruptcy Tax Act modifies existing Code provisions to permit the carryover of favorable tax attributes in bankruptcy proceedings.

124. *See* notes 110-12 and accompanying text *supra* for a discussion on how the income recognition rules are altered on stock-for-debt exchanges.

125. I.R.C. § 337 (amended 1980).

126. 1956-2 C.B. 189. In *Revenue Ruling 56-283* a corporation was in equity receivership proceedings under section 77B of the Bankruptcy Act (since superceded). The court approved a plan of liquidation in which all of the assets of the corporation would be sold for cash, and most of the cash then distributed to the creditors of the corporation in order of priority. Even though the corporation would be dissolved within 12 months of the sale of the assets, the Service held that the corporation would recognize gain on the sale of the assets because section 337 of the Code was inapplicable to situations where shareholders were not going to receive the sale proceeds.

127. 1973-1 C.B. 178. *Revenue Ruling 73-264* just modified *Reveune Ruling 56-387* in non-material part.

tion may sell its assets, and disburse the sale proceeds to its creditors, without recognizing gain or loss on the sale.[128]

Section 541 of the Code imposes a tax of seventy percent on the income of "personal holding companies."[129] A "personal holding company" is defined by section 542 of the Code as a corporation which derives most of its income from passive investments.[130] In *In re I.J. Knight Realty Corp.*[131] the Service imposed the personal holding company tax on a bankrupt company where, prior to liquidation, the company's assets had been converted into investments which produced passive income. The Bankruptcy Tax Act exempts companies undergoing insolvency proceedings from the personal holding company tax, unless the principal purpose for which the company entered bankruptcy was to avoid the personal holding company tax.[132]

IV. CRITIQUE AND CONCLUSION

The most controversial portions of the Bankruptcy Tax Act concern its impact on the net operating loss carryovers of insolvent companies, the disparate treatment it accords short-term and long-term creditors in regard to the recognition of income on stock-for-debt exchanges, and the non-recognition treatment it provides corporate debtors on stock-for-debt exchanges.[133]

During the hearings on the Act, experts in bankruptcy, finance, and tax law counseled against any rule correlating the reduction of a cor-

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128. *See* I.R.C. § 337(g).

129. *Id.* § 541.

130. *Id.* § 542.

131. 366 F. Supp. 450 (E.D. Pa. 1973). In *I.J. Knight Realty Corp.* only a passing reference is made about the Service's imposition of the personal holding company tax on the bankrupt company. 366 F. Supp. at 452. However, it has been stated that *I.J. Knight Realty Corp.* is the one reported decision in which the Service "took the position that a corporation subject to the jurisdiction of the bankruptcy court was a personal holding company." *House Hearings on H.R. 5043, supra* note 2, at 185 (statement of the American Bar Ass'n, Section on Taxation).

132. I.R.C. § 542(c)(9).

133. *See* Written Comments, *supra* note 2, at (v) (statement of Rep. Rostenkowski); *id.* at 7 (statement of the American Bar Ass'n, Section on Taxation). The American Bar Association observed that the passage of the Bankruptcy Tax Act was delayed:

> because of the controversy surrounding . . . the question of whether net operating loss carryovers and other tax attributes of a debtor undergoing reorganization should be reduced when the income from debt cancellation in bankruptcy is realized but not recognized. A subsidiary question is whether any attribute reduction rules should apply where the debt cancellation is accomplished by the issuance of stock to a corporation's creditors.

Id. Representative Rostenkowski noted that attribute reduction rules are a main "area of apparent controversy." *Id.* at (v).

poration's NOL to the reduction in debt that occurs in insolvency proceedings.[134] According to these experts, the NOL is one of the most important tax attributes possessed by an insolvent debtor.[135] They argued that an insolvent corporate debtor often needs its NOL in order to convince its creditors that its future cash flow will be sufficient to pay off claims or to provide a return on investment to claims transformed into equity.[136] On the other hand, the Service and some other tax experts

134. *See id.* at 10-12 (statement of Robert M. Zinman on behalf of the American Council of Life Insurance); *id.* at 41-42 (statement of Walter Lamp on behalf of Chase Manhattan Bank, NA); *id* at 56-59 (statement of Wilbur P. Cochran, Vice President and Tax Counsel, of the First National Bank of Chicago); *id.* at 68-69 (statement of Herbert Katz, United States Bankruptcy Judge); *id.* at 77-78 (statement of Elmer Dean Martin III); *id.* at 78-80 (statement of James E. Moriarty, United States Bankruptcy Judge); *id.* at 80-82 (statement of Norman H. Nachman); *id.* at 88 (statement of the Comm. on Bankruptcy and Corporate Reorganization of the Ass'n of the Bar of the City of New York); *House Hearing on H.R. 5043, supra* note 2, at 44 (statement of Myron Sheinfeld, Chairman, Comm. on Tax Matters, Nat'l Bankruptcy Conference); *id.* at 61-88 (statement of Elmer Dean Martin III, Chairman, Bankruptcy Tax Revision Comm. Tax Section, State Bar of California); *id.* at 111 (statement of Robert A. Bergquist); *id.* at 171-74 (statement of the American Bankers Ass'n submitted by John J. Jerome of Milbank, Tweed, Hadley & McCloy); *id.* at 188-89 (statement of Metropolitan Life Insurance Co.); *id.* at 94-95 (statement of Richard L. Bacon).

135. *See, e.g.,* Written Comments, *supra* note 2, at 10-12 (statement of Robert Zinman on behalf of the American Council of Life Insurance); *id.* at 68-69 (statement of Herbert Katz, United States Bankruptcy Judge); *id.* at 88 (statement of the Comm. on Bankruptcy and Corporate Reorganization of the Ass'n of the Bar of the City of New York); *House Hearings on H.R. 5043, supra* note 2, at 61-68 (statement of Elmer Dean Martin III, Chairman Bankruptcy Tax Revision Comm., Tax Section, State Bar of California); *id.* at 171-74 (statement of the American Bankers Ass'n, submitted by John J. Jerome of Milbank, Tweed, Hadley & McCloy). The American Bankers Ass'n stated that NOL's are a "key element in the rehabilitation of insolvent debtors . . . ." *Id.* at 173. Elmer Dean Martin III stated that the availability of NOL's "is a significant consideration in obtaining creditor acceptance of a plan of reorganization . . . ." *Id.* at 65. The Committee on Corporate Reorganization of the New York City Bar Ass'n stated that the NOL is the most important tax attribute of a reorganized company. Written Comments, *supra* note 2, at 88. Herbert Katz, a United States Bankruptcy Judge stated: "It has been my experience that the ability to defer taxes on future income through tax loss carryforwards and net operating losses has been a *most valuable tool* usable by a debtor in proposing its plan of arrangement with its creditors." *Id.* at 68 (emphasis added); Robert Zinman of the American Council of Life Insurance stated that "[tax] attributes, particularly the Net Operating Loss carryovers, are a substantial value to the reorganized corporation." *Id.* at 11. Investors in bankrupt companies have long realized the benefits of a company's NOL's, *see* FORBES, April 13, 1981, at 204. An article entitled "From the Ashes," declares: "Ever since Old Penn Central Transportation Company was restructured in 1978, a single paper asset has proven more valuable to the company's success than all the old tracks, locomotives and equipment put together: The asset's tax loss carryforwards."

136. Written Comments, *supra* note 2, at 41-42 (statement of Walter Lamp on behalf of the Chase Manhattan Bank, NA); *id.* at 56-59 (statement of Wilbur P. Cochran, Vice President and Tax Counsel, First Nat'l Bank of Chicago); *id.* at 80-82 (statement of Norman H.

argued that attribute reduction is sound tax policy.[137] According to this second group of experts, if the pre-bankruptcy NOL of a corporate debtor survives bankruptcy proceedings, then bankruptcy will give the debtor, not a fresh start, but a head start,[138] because the debtor will receive the benefit of not recognizing debt discharge income, and yet at the same time be able to shelter future income with an NOL probably generated from loan proceeds, which, after bankruptcy, no longer have to be repaid.[139]

In this instance Congress decided to accomodate the economic realities of bankruptcy at the expense of strict adherence to theoretical tax principles by modifying sections 108 and 1017 of the Code. Instead of mandating the reduction of the NOL in correlation to the reduction in debt, in modifying section 108 Congress granted the debtor the option of first reducing basis.[140] In this author's view, such a compromise is equitable. By permitting asset basis to be reduced in lieu of the NOL, the possibility of creating a viable plan of reorganiza-

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Nachman); *House Hearings on H.R. 5043*, *supra* note 2, at 44 (statement of Myron M. Sheinfeld, Chairman, Comm. on Tax Matters, Nat'l Bankruptcy Conference); *id.* at 61-88 (statement of Elmer Dean Martin III, Chairman, Bankruptcy Tax Revision Comm., Tax Section, State Bar of California). Wilbur P. Cochran of the First National Bank of Chicago stated:

> We oppose . . . attribute reduction. . . . [A]ttribute reduction will severely limit cash flow for debtors who recover sufficiently to earn taxable income. Future cash flow is an important factor in creditors' decisions to restructure and forgive debt and any change in the tax law which reduces cash flow will result in the liquidation of some businesses which would be continued under present law.

Written Comments, *supra* note 2, at 57. Similarly, Myron M. Sheinfeld observed: "The utilization, in the reorganized future of the business debtor, of an NOL is sometimes critical to the projected economic viability of the debtor's enterprise. It is through utilization of NOL carryback and carryforward that creditors . . . frequently rely on demonstrating some reasonable assurance of future payment." *House Hearing on H.R. 5043*, *supra* note 2, at 44. The other authorities cited make similar comments.

137. Written Comments, *supra* note 2, at 7-8 (statement of the American Bar Ass'n, Section of Taxation); *id.* at 20-29 (statement of Richard L. Bacon); *id.* at 49-50 (statement of Jeffrey D. Eicher); *id.* at 91-92 (statement of the Committee on Taxation of the Bar Ass'n of the City of New York); *House Hearings on H.R. 5043*, *supra* note 2, at 8-9 (statement of Daniel I. Halperin, Deputy Ass't Sec'y for Tax Policy, Dep't of the Treasury); *id.* at 90-94 (statement of Richard L. Bacon); *id.* at 178 (statement of ABA); *House Hearings on H.R. 9973*, *supra* note 2, at 69-70 (statement of Daniel I. Halperin).

138. Written Comments, *supra* note 2, at 50 (statement of Jeffrey Eicher); *id.* at 91 (statement of the Committee on Taxation of the Bar Ass'n of the City of New York); *House Hearings on H.R. 5043*, *supra* note 2, at 7 (statement of Daniel I. Halperin, Deputy Ass't Sec'y for Tax Policy, Dep't of Treasury); *House Hearings on H.R. 9973*, *supra*, note 2, at 69 (statement of Daniel I. Halperin); *id.* at 79 (statement of M. Carr Ferguson, Ass't Attorney General, Tax Division, Dep't of Justice.

139. *See* the authorities cited in note 131 *supra*.

140. *See* notes 31-41 and accompanying text *supra* for a discussion on the tax attribute and basis reduction rules under the Bankruptcy Tax Act.

tion for the insolvent debtor is greatly enhanced, since needed cash will not be diverted immediately to make tax payments. On the other hand, because the debtor has to reduce asset basis if it does not reduce its NOL, the loss of its future depreciation deductions will increase its future income, thereby encouraging the rapid depletion of the NOL.

With respect to the disparate treatment accorded short-term and long-term creditors under the Bankruptcy Tax Act, the bankruptcy experts argued that all creditors should be treated the same.[143] The experts predicted it would be more difficult to create a viable plan of reorganization if the unsecured creditors would be taxed on the receipt of stock.[142] In all probability the unsecured creditors would demand to receive some cash with which to pay the tax, and any disbursement of cash from an insolvent debtor increases the likelihood of the debtor's eventual financial failure.[143] In contradistinction, it has been argued that unsecured creditors should recognize income on the receipt of stock because the very same creditors will have recognized previously an ordinary loss on the purported worthlessness of their claims under section 166 of the Code.[144]

To this author's mind, the latter argument is sound. If the unsecured creditor takes a bad debt deduction upon the debtor's bankruptcy, he is entitled to offset ordinary income to the extent of the deduction.[145] Subsequently, if the unsecured creditor receives stock in exchange for his purportedly worthless claim, the only way to prevent the creditor from receiving an unwarranted tax benefit is to require him to recognize income on the receipt of the stock.[146]

In regard to the corporate debtor's recognition of income on stock-for-debt exchanges, it was originally proposed that debt discharge income should be recognized to the extent that the principal amount of any short-term debt discharged exceeded the value of the stock given.[147] Only after a storm of protest was registered by members of

141. *House Hearings on H.R. 5043, supra* note 2, at 208-11 (statement of the New York State Bar Ass'n, Report on Certain Provisions of H.R. 5043).

142. *Id.*

143. *Id.*

144. *Id.* at 210.

145. I.R.C. § 166 allows both wholly and partially worthless loans to be deducted as ordinary losses from the creditor's income.

146. I.R.C. § 111, the codification of the tax benefit rule, provides that any amount attributable to the recovery during the taxable year of a bad debt which was allowed as a deduction from gross income in a prior year must be included in gross income for the year of recovery. I.R.C. § 111. Thus, under I.R.C. § 111, the creditor's receipt of stock should be included in the creditor's income where the creditor has taken a bad debt deduction with respect to the claim surrendered for the stock. For a discussion on the tax benefit rule, see Bittker & Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L. REV. 265 (1978).

147. *See* Proposed H.R. 5043, § 108(e)(1)(A), *reprinted in* HOUSE REPORT ON H.R. 5043, *supra* note 2, at 43. The House Report stated that under its proposed version of the

the bankruptcy, tax, and finance bars, was it determined that debt discharge income would be recognized by the corporate debtor on stock-for-debt exchanges only where short-term creditors received relatively small amounts of stock.[148]

In this author's view, the compromise reached is sound. Under the prior law, the issuance of stock for debt was viewed, not as a payment of the debt liability, but as a transformation of the liability into a different form.[149] Where there is such a continuity of interest, nonrecognition principles should apply.[150] Furthermore, debt discharge income is imputed income, and thus, no cash is produced with which to

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Bankruptcy Tax Act, if a "corporate debtor issues stock to its creditor for the principal amount of an outstanding security (such as a bond), there is no debt discharge amount and no attribute reduction is required." HOUSE REPORT ON H.R. 5043, *supra* note 2, at 13. However, the House Report stated that under the proposed bill, "[i]f a corporate debtor issues stock for other debts (such as debts held by trade creditors or by a lender holding a short-term note), the corporation is to be treated as having satisfied the debt with an amount of money equal to the stock's fair market value." *Id.* at 14. The House Report illustrated the operation of the proposed stock-for-debt income recognition rule with the following example:

> [A]ssume a corporate debtor borrows $1,000 on a short-term note and later issues $600 worth of stock in cancellation of the note. Under present law, the creditor recognizes a $400 loss, but the corporate debtor neither recognizes income nor must reduce tax attributes. Under the bill, the creditor recognizes a $400 loss (as under present law) and the corporation must account for debt discharge amount of $400.
>
> If the corporation is insolvent or in bankruptcy, it must apply the $400 debt discharge amount to reduce tax attributes . . . .

Id. at 14 n.19. Representatives of the Treasury Department supported the proposed stock-for-debt rule on the grounds of tax symmetry, that is, while a creditor would recognize a bad debt loss on the exchange, there would be an offsetting gain by the debtor corporation since it would recognize debt discharge income. *See House Hearings on H.R. 5043*, *supra* note 2, at 9-10 (statement of Daniel I. Halperin); *id.* at 90-91 (statement of Richard L. Bacon); Written Comments, *supra* note 2, at 29-32 (statement of Richard L. Bacon).

148. *See* note 44 and accompanying text *supra* for a discussion of the compromise embodied in the Bankruptcy Tax Act. The protestations to the proposed stock-for-short-term debt rule can be found at HOUSE HEARINGS ON H.R. 5043, *supra* note 2, at 53-55 (statement of David A. Berenson, Chairman, Bankruptcy Task Force, American Inst. of Certified Public Accountants); *id.* at 111-12 (statement of Robert A. Bergquist, Esq.); *id.* at 172 (statement of the American Bankers Ass'n); *id.* at 179 (statement of the Section on Taxation of the American Bar Ass'n); *id.* at 191 (statement of the Comm. on Taxation of the Bar of the City of New York); Written Comments, *supra* note 2, at 8-9 (statement of the American Bar Ass'n, Section on Taxation); *id.* at 10-11 (statement of the American Council of Life Insurance); *id.* at 42-43 (statement of Chase Manhattan Bank, N.A.); *id.* at 86 (statement of Comm. on Bankruptcy and Corporate Reorganizations, Ass'n of the Bar of the City of New York).

149. *See, e.g.*, Revenue Ruling 59-222, 1959-1 C.B. 80. *See* note 92 *supra* for an in-depth discussion on *Revenue Ruling 59-222*.

150. *Accord*, Written Comments, *supra* note 2, at 8-9 (statement of the American Bar Ass'n, Section on Taxation).

pay taxes levied on the income.[151] Accordingly, where an insolvent company recognizes debt discharge income, its tax payments have to come from its pre-existing cash reserves, and any disbursement of cash by an insolvent company enhances the possibility of that company's ultimate failure.[152] Thus, in order to prevent the liquidation of insolvent companies, it is necessary to minimize their forced recognition of imputed income.[153]

In conclusion, it is observed that the Bankruptcy Tax Act is a compromise bill[154] in which Congress attempted to accomodate both bankruptcy policy and tax theory. Thus, the provisions of the Act often are theoretically unsound when viewed from either a pure tax or pure bankruptcy perspective.[155] However, despite any theoretical shortcomings, the Bankruptcy Tax Act should be welcomed by both bankruptcy and tax practitioners for the statutory framework it provides for determining the tax consequences attendent to insolvency proceedings.[156] The certainty provided by the new statute should be infinitely preferable to the ambiguities inherent in the prior law.[157]

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151. Written Comments, *supra* note 2 at 17 (statements of Ass'n of American Railroads).

152. Written Comments, *supra* note 2, at 38 (statement of James M. Barton); *id.* at 59-60 (statement on behalf of General Telephone & Electronics Corp.); *id.* at 74 (statement of Machinery and Allied Products Inst.).

153. *Id.*

154. *Accord, House Hearings on H.R. 5043, supra* note 2, at 8 (statement of Daniel I. Halperin). Mr. Halperin stated that the Bankruptcy Tax Act "is a compromise bill as it must be. It accommodates competing tax and bankruptcy policies."

155. Compare the views of the authorities cited in note 128 *supra* with the views of the authorities cited in note 131 *supra* for the contrasting opinions of the bankruptcy and tax practitioners.

156. *Accord, House Hearings on H.R. 5043, supra* note 2, at 4 (statement of Daniel I. Halperin); Written Comments, *supra* note 2, at 87 (statement of the Committee on Bankruptcy and Corporate Reorganization of the Ass'n of the Bar of the City of New York). The Bankruptcy Comm. of the New York City Bar Ass'n stated: "The provisions of the Bankruptcy Tax Act . . . clarify, and, for the most part, represent an improvement over existing law." *Id.* Mr. Halperin stated that the Bankruptcy Tax Act "is a significant and positive advance in clarifying the application of the tax laws to persons in financial distress." *House Hearings on H.R. 5043, supra* note 2, at 4.

157. For one example of the ambiguity of existing case law, see note 67-82 and accompanying text *supra.*